Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Nuñez, et al. Analyst: Anne Mazur Bill Number: AB 8

Related Bills: See Legislative History Telephone: 845-5404 Amended Dates: May 1, 2007; April 18, 2007; March 29, 2007

Attorney: Patrick Kusiak Sponsor:

SUBJECT: Require Employers To Establish Section 125, Cafeteria Plans

SUMMARY

This bill would do the following:

- Create the California Cooperative Health Insurance Purchasing Program (Cal-CHIPP) to serve as a health care purchasing pool for employers and make other changes to health care related provisions of several California Codes.
- Require employers to make health care expenditures or elect to pay an in-lieu fee to a specified fund.
- Require employers to set up a cafeteria plan under Internal Revenue Code (IRC) section 125 (125 mandate).

Discussion in this analysis is limited to those provisions of the bill that affect the Franchise Tax Board (FTB).

SUMMARY OF AMENDMENTS

The March 29, 2007, amendments deleted intent language relating to universal health care coverage and added provisions that would add and amend multiple California codes relating to the provision of health care coverage, including establishing health insurance market reforms, encouraging wellness, expanding the number of children eligible for subsidized programs, creating a new statewide purchasing pool, imposing a fee on employers, and requiring certain employers to establish 125 plans.

The April 18, 2007, amendments revised the 125 mandate language by replacing the term “health benefits, including premiums” with the term “health insurance premiums.” The amendments also made technical and substantive changes to provisions that do not impact FTB.

The May 1, 2007, amendments added co-authors and made substantive and technical changes that do not impact FTB.

This is the department’s first analysis of this bill.

Board Position:			Department Director	Date
_____ S	_____ NA	_____ NP		
_____ SA	_____ O	_____ NAR	Selvi Stanislaus	5/31/07
_____ N	_____ OUA	___X___ PENDING		

PURPOSE OF THE BILL

According to the intent language of the bill, the purpose of this bill is to achieve the first step towards a goal of universal health care coverage for all California residents.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2008. Sections of the bill would become operative on July 1, 2008, or January 1, 2009. Unspecified sections, including the section providing for the 125 mandate, would become operative on January 1, 2008.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Current federal laws allow employers to extend certain benefits, including health care benefits, to employees without requiring inclusion of such benefits in the gross income of employees. For example, employees can exclude from gross income amounts received from an employer, directly or indirectly, as reimbursement for expenses for the medical care of the employee, the employee's spouse, and the employee's dependents. An employee also excludes from gross income the cost—that is, premiums paid—of employer-provided coverage under an accident or health plan.[1] Insurance premiums paid for partners and more-than-2% S corporation shareholders are not excludable. Highly compensated individuals who benefit from an employer's "self-insured" medical reimbursement plan that discriminates in favor of "highly compensated employees," as those terms are defined, must include in income benefits not available to other participants in the plan.[2]

Under IRC section 125, current federal law allows employers to offer a choice of benefits—assuming such benefits are otherwise excluded from gross income under a specific provision of the IRC— or cash to employees. A plan under IRC section 125 is also known as a "cafeteria plan." It is a written plan under which employee-participants may choose their own "menu" of benefits consisting of cash and "qualified benefits." No amount is included in the gross income of the employee-participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan. Employer contributions to a cafeteria plan can be made under a salary reduction agreement with the employee-participant if it relates to compensation that hasn't been received by, and does not become currently available to, the participant.

A cafeteria plan can also include "flexible spending accounts" (FSAs) that are funded by employee contributions on a pre-tax salary reduction basis to provide coverage for specified expenses—such as qualified medical expenses or dependent care assistance—that are incurred during the coverage period and may be reimbursed.

[1] Internal Revenue Code section 106.
[2] Internal Revenue Code section 105(h).

IRC section 125 provides special rules with respect to plans that discriminate based on eligibility and benefits in favor of "highly compensated participants" and "key employees."

The practical benefit of cafeteria plans is that employees may make contributions in payment of benefits, such as insurance premiums, on a pre-tax basis. Such contributions reduce the amount of wages that would otherwise be subject to social security and Medicare taxes for both the employee and employer. [3] Federal law does not require employers to establish cafeteria plans and does not mandate the type of benefit choices offered in the plan as long as the benefits are otherwise "qualified" under applicable provisions of the IRC.

California generally conforms to federal law in this area.

THIS BILL

This bill would require employers to make health care expenditures, at an unspecified percentage of social security wages, or elect to pay an in-lieu fee in an equivalent amount for employees who would be required to enroll in Cal-CHIPP. Cal-CHIPP, which would be established by this bill, would serve as a health care purchasing pool for employees of employers electing the in-lieu fee. The fee would be collected and administered by the Employment Development Department (EDD) and deposited into the California Health Trust Fund for purposes of providing health care coverage.

This bill would also require "employers in this state" to adopt and maintain a cafeteria plan under IRC section 125 for the purpose of allowing employees to pay for health insurance premiums.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

The bill provides "Unless federal law or the law of this state provides otherwise, each employer in this state…" must adopt and maintain a cafeteria plan. It is not clear what certain terms in the preceding phrase are intended to mean. Presumably, the limitations with respect to "federal law" are intended to reflect that California cannot enact laws to compel action by the federal government, unless the federal government has a law to require such action. In this case, California could not compel a federal employer to adopt and maintain a cafeteria plan for its employees. The same problem would probably exist for a federally recognized Indian Tribe. The phrase "employer in this state" also lacks clarity. Another provision of the bill (on page 36, beginning on line 38) defines "employer" for purposes of that section—relating to employers that may elect to pay a fee in lieu of making health care expenditures. The author may wish to consider referencing that same definition for purposes of the 125 mandate.

[3] For federal purposes, under the Federal Insurance Contributions Act (FICA), in addition to withholding for personal income tax, wages are subject to withholding for both social security (also known as OASDI for Old Age, Survivors, and Disability Insurance) and Medicare. For 2007, the social security tax wage base limit is $97,500. The employee tax rate is 6.2%, for a maximum contribution of $6,045. The employee tax rate for Medicare is 1.45%. There is no wage base limit for Medicare tax. Employers are required to pay social security and Medicare tax on wages paid in the same amount of the employee contribution.

Although the bill would place the 125 mandate language in the parts of the Revenue and Taxation Code administered by FTB, it is unclear which state department would be responsible for enforcing this mandate. Generally, EDD administers employer-related laws and has an existing reporting and enforcement relationship with businesses in the businesses' capacity as employers.

The bill would not provide a consequence for failure to comply with the mandate. The author may wish to consider an appropriate enforcement tool to encourage compliance with the mandate.

TECHNICAL CONSIDERATIONS

Because the 125 mandate in this bill would place a requirement on employers to provide a mechanism for employees to purchase health care benefits with pre-tax dollars, this provision might more appropriately reside in another code, such as the Labor Code, where it would have statutory proximity to the employer in-lieu election.

LEGISLATIVE HISTORY

SB 48 (Perata, 2007/2008) would establish the California Health Care Coverage and Cost Control Act, which would require every individual with income subject to the Personal Income Tax to maintain a minimum policy of health care beginning January 1, 2011. The bill would also permit employers to elect to pay a fee in lieu of making health care expenditures and mandate certain employers to adopt and maintain an IRC section 125 plan. The bill is currently in the Senate Health Committee.

SB 820 (Ashburn, 2007/2008) would allow a 15% credit against franchise and income tax for administrative costs incurred by an employer in connection with establishing a cafeteria plan that provides health benefits to employees. The bill is currently in the Senate Health Committee.

SB 840 (Kuehl, et al., 2007/2008) would create the California Health Insurance system that would provide health care benefits to all individuals in the state. It would also create the California Health Insurance Premium Commission. FTB's Executive Officer would be required to be a member of the commission. This bill passed as amended by the Senate Health Committee and has been referred to Senate Appropriations.

SB 1014 (Kuehl, 2007/2008) would impose additional taxes on individuals and employers to fund a universal health care plan. The bill is currently in the Senate Revenue and Taxation Committee.

FISCAL IMPACT

The department's costs to administer this bill cannot be determined until implementation concerns are fully identified and resolved, but could be significant depending on whether and to what extent FTB would be responsible for administering and enforcing the 125 mandate. The additional costs will be developed as the bill moves through the legislative process. It is recommended that the bill be amended to include appropriation language that would provide funding to implement this bill. Lack of an appropriation will require the department to secure the funding through the normal budgetary process, which will delay implementation of this bill.

ECONOMIC IMPACT

The revenue impact of this bill would depend on the increase in the amount of employee health insurance, the use of section 125 plans, and employee tax rates. At this time, it is not possible to estimate the revenue impact for this bill due to lack of certain specifics, such as the minimum rate that employers would be required to contribute to their employee's health insurance.

Department staff has estimated that for every $100 million increase in employee health insurance that is paid through section 125 plans, there would be a revenue loss of approximately $5 million. This loss would arise because the $100 million would be treated as a reduction in taxable wages due to the pre-tax benefit of section 125 plans. This $100 million reduction in taxable wages would result in a $5 million revenue loss, assuming an average marginal tax rate for individuals of about 5%.

LEGAL IMPACT

The 4th Circuit U.S. Court of Appeals in *Retail Industry Leaders Association v. Fielder* (2007) 475 F.3d 180 ruled that Maryland's Fair Share Health Care Fund Act (Act) is preempted by ERISA[4] because the Act directly regulates employers' provision of healthcare benefits, and therefore has a "connection with" covered employers' ERISA plans. The Act required every employer of 10,000 or more Maryland employees to pay to Maryland an amount that equals the difference between what the employer spends on "health insurance costs" and 8% of its payroll. The court invalidated the Act, concluding that the effect of the Act is to mandate health care spending increases and leaves employers no reasonable choices except to change how they structure their employee benefit plans. The Maryland Attorney General did not appeal this decision. Although the effects of this decision on the applicable laws of other states, including California, is unknown, similar mandates involving covered ERISA plans may also be preempted by ERISA.

LEGISLATIVE STAFF CONTACT

Anne Mazur
Franchise Tax Board
(916) 845-5404
anne.mazur@ftb.ca.gov

Brian Putler
Franchise Tax Board
(916) 845-6333
brian.putler@ftb.ca.gov

[4] Federal Employee Retirement Income Security Act of 1974.